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No. 97-1652

In the Supreme Court of the United States

OCTOBER TERM, 1997

NORTHWESTERN INDIANA TELEPHONE COMPANY, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether, on the particular facts of this case, litigation costs incurred by petitioner Northwestern Indiana Telephone Company in contesting asserted violations of Federal Communications Commission rules were not deductible by it as ordinary and necessary business expenses under Section 162 of the Internal Revenue Code, 26 U.S.C. 162.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-12) is reported at 127 F.3d 643. The opinion of the Tax Court (Pet. App. 13-110) is reported at 71 T.C.M. (CCH) 2674.

JURISDICTION

The judgment of the court of appeals was entered on October 22, 1997. A petition for rehearing was denied on January 7, 1998 (Pet. App. 118-119). The petition for a writ of certiorari was filed on April 7, 1998. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner Northwestern Indiana Telephone Company (NITCO) is an independent telephone company that provides local telephone service in rural Indiana (Pet. App. 2). For more than 50 years, NITCO has been wholly owned by the family of Robert G. Mussman (*ibid.*). Mr. Mussman personally owned more than 95 percent of the stock. His son Rhys was employed by NITCO at various times and was also engaged in his own business venture (Pet. App. 3).

In 1983, Rhys incorporated Northwestern Indiana CableVision under the name NICATV to provide cable TV service in rural Indiana (Pet. App. 3). Although NITCO had no ownership interest in NICATV or its facilities, NITCO subsidized NICATV in a variety of ways (*ibid.*). For example, NITCO made regular payments to Rhys in amounts that approximated the salary he had earned when he was an employee at NITCO (Pet. App. 6). NITCO employees were also used to construct and operate the cable television system owned by NICATV in several locations (*ibid.*). And, in 1989, NITCO wrote off as "uncollectible" a debt of $122,000 owed to it by NICATV even though in July of that year Rhys sold NICATV to an unrelated third-party for $4 million (*ibid.*).

2. In October 1983, Comark Cable Fund III, a cable television competitor of NICATV, filed a complaint with the Federal Communications Commission in which it alleged that NICATV and NITCO were affiliated companies engaged in anticompetitive conduct in violation of the Communications Act of 1934 and FCC regulations (Pet. App. 3-4). The FCC agreed that NICATV and NITCO were "affiliated" compa-

nies and that the construction of cable facilities by NITCO for NICATV without prior FCC authorization violated Section 214(a) of the Communications Act of 1934, 47 U.S.C. 214(a) (Pet. App. 4). NITCO and NICATV were ordered by the agency to divest themselves of all cable television facilities constructed in violation of FCC rules, to terminate all improper affiliations and to negotiate a good faith settlement with Comark. The FCC also imposed a fine of $20,000 on NITCO (*ibid.*).

NICATV and NITCO reached a settlement with Comark in November 1985 but refused to comply with the divestiture order while the appeal from that order was pending. That refusal gave rise to an enforcement action by the United States and to a constitutional challenge to the agency rules by NITCO and Rhys (Pet. App. 4). After the FCC divestiture order was sustained on appeal (*ibid.*), Rhys sold NICATV to an unrelated third-party for $4 million in 1989 (*id.* at 6). In connection with these various lawsuits, NITCO incurred legal fees in excess of $700,000 for which it claimed an income tax deduction on its 1987-1989 returns (*id.* at 4).

3. The Internal Revenue Service disallowed the deductions claimed by NITCO for the legal fees incurred in the FCC litigation. Because these legal fees were incurred for the benefit of Robert Mussman, rather than for any business purpose of NITCO, the Service further concluded that the payment of the fees by the corporation represented a constructive dividend that constituted taxable income for Robert Mussman (Pet. App. 15-16).

4. The Tax Court upheld the Commissioner's determinations. The court concluded that the deductions claimed by NITCO for legal fees expended on

the FCC litigation should be disallowed under the "origin-of-the-claim" test adopted by this Court in *United States* v. *Gilmore*, 372 U.S. 39, 49 (1963) (Pet. App. 81). The Tax Court found, on the specific facts and circumstances of this case, that NITCO's transactions with NICATV and its improper affiliation with NICATV (which was the origin of the litigation and therefore of the litigation expenses) were not the result of an attempt by NITCO to enter the cable television business but were instead the result of Robert Mussman's decision to use his personal control over NITCO to subsidize his son's independent business efforts (Pet. App. 82). The court determined that the legal fees incurred by NITCO in challenging the FCC's rulings resulted from the personal activities of the owner, not the business activities of the corporation, and therefore did not constitute ordinary and necessary business expenses deductible under Section 162 of the Internal Revenue Code (*id.* at 84-86). The Tax Court sustained the determination that the payment of these fees represented a constructive dividend to Robert Mussman (*id.* at 87-88).

5. The court of appeals affirmed (Pet. App. 1-12). The court held that, in applying the origin-of-the-claim test established in *Gilmore*, the Tax Court had correctly examined whether the claim "grew out of the profit-making activity of NITCO" or was instead personal in origin (*id.* at 6). The court concluded that the litigation did not arise from the business or profit-making activities of NITCO but instead arose from Robert Mussman's exercise of his control over NITCO to subsidize his son's cable television business venture (*ibid.*). Because the origin of the claim was in the personal interests of the contolling shareholder rather than the business of NITCO, the court

concluded that the payment of the litigation fees by the corporation constituted a constructive dividend to Robert Mussman (*id.* at 7).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review of the inherently factual determinations of the courts below is not warranted.

1. Section 162(a) of the Internal Revenue Code allows a deduction for all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." 26 U.S.C. 162(a). Litigation expenses may be deducted as ordinary and necessary business expenses under Section 162(a) only when the litigation arises in connection with the profit-seeking activity of the taxpayer. *United States* v. *Gilmore*, 372 U.S. 39, 48 (1963). If the origin of the legal action is not in the business activity of the taxpayer, expenditures on legal fees are not deductible without regard to the motivation of the taxpayer or the potential effect of the litigation on the financial fortunes of the taxpayer. See *id.* at 49; *Anchor Coupling Co.* v. *United States*, 427 F.2d 429, 431 (7th Cir. 1970); *In re Collins*, 26 F.3d 116 (11th Cir. 1994).

In the present case, the litigation arose from a complaint filed with the FCC by a television competitor of NICATV that challenged the improper affiliation of NITCO with NICATV. The courts below correctly found, on the facts of this case, that the origin of that claim was not in the ordinary and necessary business activities of NITCO but was in the personal use of the assets of NITCO by its controlling shareholder to subsidize the efforts of a family member. Based upon

that factual determination, the courts correctly concluded that the legal fees incurred by NITCO were not deductible as ordinary and necessary business expenses under Section 162 of the Code (Pet. App. 6-7, 82-86).

As the courts below concluded, the involvement of NITCO in the business activites of NICATV was not part of any attempt by NITCO to expand its telephone business into the cable television business. The improper affiliation of NITCO and NICATV was the product of Robert Mussman's desire to assist the cable television business operated by his son Rhys. Although Mussman caused his corporation to expend resources to assist his son's business, NITCO did not stand to profit from the assistance it provided to NICATV. The transactions between NITCO and NICATV represented a gratuitous attempt by a father to use his corporation to enhance the business of his son (Pet. App. 6-7, 82-85). The detailed findings concurred in by both of the courts below do not warrant further review. See, *e.g.*, *Tiffany Fine Arts, Inc.* v. *United States*, 469 U.S. 310, 317-318 n.5 (1985).

2. Petitioners err in claiming (Pet. 12-13) that the court of appeals incorrectly focussed not on the origin of the claim against NITCO but on its motives in providing assistance to NICATV. Whether an expense is business-related within the meaning of Section 162 necessarily involves a determination whether a nexus exists between that expense and a profit-seeking activity of the taxpayer. See *United States* v. *Gilmore*, 372 U.S. at 48; *International Trading Co.* v. *Commissioner*, 275 F.2d 578 (7th Cir. 1960). The presence or absence of a profit motive is critical in determining whether the activity constitutes a trade or business for purposes of deductibility under

Section 162. The origin-of-the-claim test developed and applied by this Court in *United States* v. *Gilmore*, 372 U.S. 39 (1963), precludes a taxpayer from attributing a theoretical or subjective business motive to an inherently personal expense. As the courts below recognized in this case, however, it does not preclude an inquiry into the existence or absence of a profit motive for an activity that the taxpayer asserts is somehow connected to its business (Pet. App. 6).

Petitioners similarly err in contending (Pet. 14-17) that the court of appeals erroneously focussed on events that were irrelevant to, or that arose after the institution of, the litigation. In determining whether the origin of the claim that gave rise to the litigation expenses was business-related, it was proper for the courts below to examine the various transactions to determine whether NITCO's involvement with NICATV was part of its profit-seeking activity or was, instead, a personal attempt by Robert Mussman to assist his son Rhys in starting his own business. In making this inquiry, it is entirely permissible for a court to "inquire whether subsequent events are consistent with its judgment of the facts available in [the year in issue]." *Levin* v. *Commissioner*, 832 F.2d 403, 406 n.3 (7th Cir. 1987).

3. The inherently factual determination of the courts below does not, as petitioners incorrectly assert (Pet. 17-20), conflict with *Kopp's Co.* v. *United States*, 636 F.2d 59 (4th Cir. 1980), and *Dolese* v. *United States*, 605 F.2d 1146 (10th Cir. 1979), cert. denied, 445 U.S. 961 (1980). In *Kopp's Co.*, a corporation deducted amounts that it paid to settle an injury claim that stemmed from a car accident caused by the son of the sole shareholder who was driving a company car on personal use. The court allowed the com-

pany to deduct the amounts paid in settlement of the claim brought against it because its business and operations were directly threatened by the lawsuit. 636 F.2d at 61. In *Dolese* v. *United States*, a corporation was permitted to deduct a portion of the litigation expenses it incurred in defending a lawsuit filed against it by the wife of its sole shareholder in connection with their divorce. The court held that the litigation expenses were deductible because the lawsuit had placed the profit-making activities of the corporation in jeopardy. 605 F.2d at 1151-1152.

The facts and circumstances of the present case are, of course, significantly different from those involved in *Kopp's Co.* and *Dolese.* In both of those cases, the corporation was required to defend its ability to conduct its for-profit business. In the present case, by contrast, NITCO acted without any business purpose in providing gratuitous assistance to the activities of the son of its principal owner. Because NITCO had no ownership or profit interest in NICATV, it had no business reason to contest the divestiture order. It was only Mr. Mussman's son, Rhys, who stood to benefit if the divestiture order were overturned. The legal fees incurred by NITCO in contesting the divestiture order and the subsequent enforcement action instituted by the United States were designed to provide an economic benefit to the son of Mr. Mussman; they were not incurred for any business purpose of NITCO.* Because these legal fees did not constitute ordinary and necessary expenses of the trade or business of NITCO, the deduction of those expenses by the corporation was

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* It is also evident that NITCO did not spend $700,000 in legal fees to avoid the $20,000 fine imposed on it by the FCC.

properly disallowed by the courts below (Pet. App. 6-7, 82-88).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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